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Ontario Pension Policy 2013: Key Challenges Ahead

Key challenges lie ahead for the reform of Ontario's pension system. Among them: making needed changes to public sector pensions, and addressing the reality that the current regime has failed many private sector workers.

Barry Gros

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About The Author

Barry Gros
is Associate Partner,
Aon Hewitt.

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Finn Poschmann
Vice-President, Research

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The Study In Brief

Since the report of an expert commission five years ago, Ontario pension standards have been updated multiple times in response – but there is still room for significant improvements.

Further action is needed in three key areas:

- the low participation rate of private sector employees in employer-sponsored plans;
- lack of legislative flexibility for jointly sponsored public sector pension plan (JSPP) designs to effectively manage the benefit/funding equation to ensure costs remain at a manageable and acceptable level; and
- ineffective funding and surplus utilization models for traditional, single-employer, defined-benefit pension plans (DB SEPPs).

With respect to sparse pension coverage, Ontario should enact the federal Pooled Registered Pension Plan (PRPP) legislative framework. However, it should be revised to require Ontario employers beyond a specified size to offer such a plan, and auto-enroll employees who would have the option to opt out. This would ensure the accumulation of assets needed to support retirement readiness and to create the scale needed to deliver on the promise of low operating costs. Furthermore, efforts should be devoted to integrate tax-free savings accounts into the PRPP package.

In the public sector, taxpayers would benefit from the province incorporating target-benefit principles into the standards governing public pension plans, fixing the contribution rate for employers and ingraining risk management principles in the operation of these plans. This would help keep plan costs in line, reduce the potential for intergenerational inequities and broaden the general understanding of these plans.

Finally, for DB SEPPs, funding levels and access to surpluses are the primary areas of concern. Current funding models could benefit from replacing the combined going-concern and solvency valuation model with a stronger going concern valuation model and a new margin reserve account. This would prevent overpayments made by employers during poor financial times to turn into trapped surpluses when times improve.

The Arthurs Report's objectives were to ensure affordable pension plans that are sustainable and operate within a clear set of unbiased rules. These goals are still within reach, provided the Ontario government implements new reforms.

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Over the past 50 years, successive governments have taken a basic concept – providing for a secure retirement – and created a complex and virtually incomprehensible system to those not working within it.

In its simplest form, a retirement-income model consists of two parts: the accumulation of assets, and regular income payments to individuals starting at some prescribed age. Where it gets complicated is in the details: what kind of guarantees get overlaid onto this simple model, who takes on investment and benefit risk, and how are those taking risk rewarded (or penalized) for taking that risk?

Five years ago, Harry Arthurs presented the Ontario government with *A Fine Balance*, the report of his Ontario Expert Commission on Pensions, the first comprehensive review of pension plans in the province for several decades. The report attempted to strike a balance among safe pensions, affordable plans and fair rules, and produced 142 recommendations. Since then, there has been continued stress on traditional defined-benefit (DB) pension plans, questioning the sustainability of the traditional DB model. Meanwhile, market volatility, low equity market returns and high costs have also challenged the viability of the traditional defined-contribution (DC) model.

Since 2008, Ontario has addressed many of the Arthurs Report's recommendations in periodic updates to pension standards. But there is still work to be done. Regulations have yet to be promulgated to implement some of the changes, and further action is needed in three key areas: coverage, plan-design flexibility and funding.

The purpose of this *Commentary* is to provide suggestions regarding these three areas of pension reform that have yet to be addressed.

An Overview

Canada has a multi-pillared retirement income system that has been well regarded internationally. The first pillar is the universal government Old Age Security (OAS) program. The second is the mandatory employment-related government Canada Pension Plan (CPP). The third is comprised of voluntary employer-sponsored pension plans and other tax-assisted programs (e.g., RRSPs and TFSAs). The final pillar consists of other savings, including home ownership and inheritances.

In the most recent *Melbourne Mercer Global Pension Index 2012*, which reviewed the retirement systems in place in 18 countries, Canada rated a B along with Sweden and Switzerland, which means that we have a sound structure with many good features, but there are some areas for improvement that differentiate it from an A-grade system. In comparison, Denmark is the sole country to achieve the highest rating, A, and the United States rated a C. The Netherlands and Australia were the only countries attaining a B+ rating. This analysis made three recommendations to improve the Canadian retirement income regime. They are:

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maintaining the real value of accrued pensions from termination-of-employment to pension commencement; increasing the level of household savings; and expanding the coverage for employees who do not have an employer-sponsored scheme.

While the B rating for our overall retirement system sounds good, our third pillar of employer-sponsored pension plans is in distress. While many factors may have contributed to eroding the quality of this third pillar, two have been the most significant:

- Much of the existing pension system was designed for a more robust economic environment. It hasn't functioned well in extended periods of low/declining interest rates and low returns in equity markets. While it remains to be seen whether any pension system can cope well in all economic environments, it's clear that the recent economic past has highlighted shortcomings in the existing system.
- The employer-sponsored pension plan landscape has radically changed. The majority of private sector employer-sponsored DB plans have been either fully converted to DC plans or closed to new members, in many cases for many years. Aon Hewitt's *2012 Retirement Trends Survey* found that nearly two-thirds (63 percent) of private sector DB pension plans operated either closed or frozen plans.

In looking at what policymakers and governments should focus on next, it's helpful to get a better view of the entire retirement plan landscape. According to the Arthurs Report, only about one-third (34.7 percent) of the paid Ontario workforce in 2005 was in a registered pension plan. Of those, 59 percent were in a jointly (employer-employee) sponsored plan, 12 percent were in an single employer pension plan (SEPP) covered by a collective bargaining agreement (CBA), 17 percent were in an employer DB SEPP not covered by a CBA and 12 percent were in a DC SEPP not covered by a CBA. Another way of looking at this is:

- 65 percent of paid workers aren't in a registered pension plan;
- 20 percent of paid workers are in jointly sponsored arrangements;
- 10 percent of paid workers are in DB SEPPs, covered by a CBA or not; and
- 4 percent of paid workers are in a DC SEPP not covered by a CBA.

While somewhat dated and representing only point-in-time coverage analysis, the story behind these numbers is telling, even more so when we know that pension plan coverage has been steadily declining since its peak of 45 percent in the early 1990s (Arthurs Report 2008). It's likely impossible to determine the ideal level of coverage, but with coverage declining, low participation in pension plans is preventing individuals from accumulating sufficient retirement assets. What's not evident from the above is that the vast majority of the 65 percent who aren't in a pension plan work in the private sector. Only a small minority of public sector employees lack pension plan coverage (i.e., 22 percent in 2006 (Vettese and Morneau, 2013)).

Effective solutions need to reflect the reality that the current pension regime has failed many private sector workers for the simple reason that it hasn't provided them with any occupation-related pension program outside of CPP. So, while the financial security of existing pension plans has been the primary focus of pension reform for the past decade, coverage is clearly the number one issue that needs to be addressed.

Effective change is never easy. It requires looking at and doing things differently. Policymakers also need to incorporate learnings from how previous approaches have contributed to where we are today. The following are some of the past strategies that I argue have to change going forward:

- ***Reliance of SEPPs to fill the pension gap*** –Pension plan coverage is sparse. Relying on employers to

fill the third pillar of the retirement system hasn't worked for much of the workforce.

- ***Reliance on a voluntary system to supplement CPP and OAS*** – While most people agree that saving for retirement is a good thing, making it happen is another matter. Behavioural studies show that it can be a challenge for voluntary programs involving deferred gratification to be successful.
- ***One-size-fits-all rules*** – When the Ontario *Pension Benefits Act* was written in the 1960s, it didn't explicitly deal with DC plans, let alone the variations of DB and hybrid plans that have evolved over time. Policymakers have struggled over this one-size-fits-all issue as various employers and different industry segments have lobbied for exclusion from solvency funding rules.

Suggested Changes

Among the Arthurs Report's more than 140 recommendations, one is particularly worth noting. Recommendation 4-8 says: "Multi-employer pension plans (MEPPs), jointly sponsored pension plans (JSPPs) and SEPPs should have separate funding rules related to their distinctive characteristics. In general, MEPPs and JSPPs should be allowed more flexibility in funding, while SEPPs should be subject to stricter funding rules."

Some of Ontario's subsequent changes to pension standards reflect this recommendation. In moving forward to complete the reform that's been started, policymakers need to keep this recommendation in mind.

Coverage

Coverage was specifically excluded from the Ontario Expert Commission's mandate, likely because existing pension legislation has never been about expanding coverage. Further reforms to the *Pension Benefits Act* should address this issue by more easily allowing pension "collectives," such as multi-employer, target-benefit plans for non-related employers.

Given the radical change in the nature of employment over the past 30 years – with the rise of self-employment and the increasing frequency at which employees change jobs – it is fitting that a growing number of individuals have retirement plans outside employer-sponsored plans. This trend highlights the importance of choosing the right platforms for delivering pensions for individuals not participating in an employer-sponsored plan in order to solidify our retirement savings system. In the coverage debate between CPP expansion or the creation of a new pension institution, it appears that the latter has emerged as a viable solution through the Pooled Registered Pension Plan (PRPP). While there has been no progress on CPP expansion, several provinces, but not yet Ontario, have passed enabling legislation for PRPPs.

In 2012, James Pierlot and Alexandre Laurin analyzed PRPP advantages and shortcomings in an earlier C.D. Howe Institute *Commentary (Pooled Registered Pension Plans: Pension Saviour – or a New Tax on the Poor?)*. They concluded that the current tax regime might prevent PRPPs from reaching their full potential.

> To the extent that PRPPs increase tax-deferred savings by workers with low and low-middle incomes, they risk being harmful because they will amount to a regressive tax increase. For middle- to upper-middle income workers, PRPPs will be of little help because they do not address the gap between DB pension plans and RRSPs in terms of accumulation room. Finally – and irrespective of working-life income – PRPPs will not pay 'real' pensions to their members.

An earlier C.D. Howe report (Ambachtsheer and Waitzer 2011) also provided some practical considerations to make PRPPs more effective, focusing on maximizing participation, default-option design and fiduciary oversight.

Various other studies have identified the two primary shortcomings of our retirement system to be (i) low-levels of participation (under our voluntary system) and (ii) the fact that middle-income earners are the least protected since lower-income individuals are well provided for under current rules and higher-income individuals have the resources to take care of themselves. The PRPP as currently constituted does not directly address either of these issues.

Not having proposed any PRPP legislation, Ontario still has the opportunity to address these shortcomings. Suggested fixes include:

- ***Mandate member contributions*** – The voluntary system has not delivered the savings most individuals need for their retirement. Retirement readiness can come about only with sufficient accumulation of assets. Furthermore, a 2012 McKinsey report highlighted the fact that retirement readiness can vary considerably by age and income cohort. While different studies have shown the majority of current retirees to be in a relatively comfortable position, we can't expect the historical factors that have contributed to this situation to reoccur in the future. With an environment of low investment returns, low interest rates and increasing longevity, regular saving becomes even more important.

  Mandated contributions would include requiring employers to enroll employees with an opt-out option. Employers with workforces below a minimum size and employers whose employees participate in a registered pension plan could be excluded from these requirements.

  While mandating employees to contribute will likely be necessary to achieve sufficient accumulation of assets, equally important will be good design in setting default contribution rates. Mandated contribution levels can be scaled so that they start off lower at younger ages and increase over time.

  Another option, reflecting the fact that lower income individuals are in less need of pillar three income, is to simply mandate contributions on specific covered earnings, say from the Yearly Maximum Pensionable Earnings (YMPE) to twice the YMPE. One of the primary factors critical to the success of PRPPs is scale, and it has yet to be demonstrated by potential PRPP providers how the scale required to achieve the desired low level of operating costs can be obtained with a purely voluntary system.

- ***Integrate PRPPs with TFSAs*** – Require that contributions on earnings up to a specific earnings level, the YMPE for example, be directed into a TFSA, with the option for members to direct these contributions to the PRPP. Based on the existing tax regime, TFSAs provide a clear tax advantage for lower-income individuals. Interestingly, the TFSA contribution limit ($5,500 for 2013) provides significant savings room for earnings up to the YMPE. Furthermore, RRSP room would be preserved for individuals to use tactically, since tax-deferred savings make the most sense when contributors can expect to see lower tax rates in the future than at the time the contributions are made.

- ***Mandate integration of retirement planning and retirement readiness testing*** – While saving for retirement is generally acknowledged as a good thing, people's needs can vary widely based on individual circumstances. PRPPs need to provide tools to help individual participants understand their own situations and savings needs in order to determine whether they might be saving too little or, in some cases, too much. These tools are already an integral part of the offerings of all major Canadian financial institutions and also need to be an integral part of the PRPP package.

Jointly Sponsored Pension Plans (JSPPs)

The vast majority of individuals employed in provincial public service roles are covered under

JSPPs. The Ontario government provides funding for these plans either directly or indirectly. While these plans have performed well in providing meaningful retirement income to their members, the Drummond Report (2012) highlighted concerns about the government's exposure to their liabilities and costs. While smoothing methods are incorporated in both JSPP accounting and funding standards – dampening the apparent rate of increase in the cost of these programs – the benefit costs, whether measured by contribution rates or accounting standards, have increased considerably over time. In the case of one JSPP, contribution rates have doubled since the inception of the plan, having increased 40 percent in the past five years.

The benefits provided by these plans have gradually expanded over the past 50 years. However, times have changed: expected returns from equity markets are down considerably, yields on long-term debt instruments are also down, the active plan membership continues to age and shrink in relationship to retirees, and pensioners' life expectancy at age 65 has increased by more than one-third. Two key areas of concern arise from these changes: funding levels – both their absolute magnitude and their upward trend – and increasing intergenerational inequity.

The issue of intergenerational inequity needs further explanation. All JSPPs are experiencing a continual increase in the proportion of retired members to active members. As a result of this demographic shift, future plan cost increases become the burden of the active membership. Under current pension standards, which prohibit the reduction of accrued (earned) benefits, there are only two ways to deal with increased costs: require active members (and employers) to pay more, or reduce benefits earned by active members going forward. While retired members will argue that their benefits were fully paid for, the truth is that while they contributed toward the cost of their benefits, they haven't actually fully paid for their benefits. The cost of the benefits they earned ended up being much greater than was anticipated when past contribution formulas were struck.

Due to the joint nature of their governance, JSPP plans likely need the least amount of additional regulation. What's missing is more direction from the government, on behalf of taxpayers, as to what is an acceptable level of cost. Also needed is sufficient legislative flexibility to manage the benefit/funding equation. The following suggestions could deal with these issues:

- ***Incorporate target-benefit principles into the rules governing JSPPs, including fixed contributions*** – A key principle of target-benefit plans is a greater ability to share risks through rebalancing the benefit/funding equation. This is one of the few ways that intergenerational equity can be managed. While some plans have begun to address this by making post-retirement indexing of future benefits contingent upon a plan's financial position, this in no way deals with the existing mass of retiree liabilities. While the politics of going in this direction are onerous, some provinces have either done this or are considering it. Under New Brunswick's shared-risk legislation, plans can be converted retroactively to shared risk, permitting the replacement of previously guaranteed indexing with ad hoc indexing. Furthermore, Quebec's Retirement System Expert Committee (2013) recommended that plans be given a five-year period to restructure, including making amendments to contractual indexing.

  Existing contribution levels for JSPPs cause one to ask: how much is too much? While there is no right answer to this question, actual contribution rates in the 20 percent to 30 percent range are already very costly for plans that are funded at least 50 percent by taxpayers. Following the release of the Drummond report, the Ontario government used the spectre of legislation to pressure public sector plans to restrict further contribution increases falling on taxpayers –

(the Ontario Municipal Employees Retirement System (OMERS), one of the country's largest pension funds, was excluded from this requirement – which led those plans to explore funding solutions on the pension benefits side.

It seems desirable and reasonable for the government, representing the taxpayers who don't have any direct say in these matters, to set a fixed amount it is willing to contribute. Setting a contribution ceiling on public sector plans was one of the recommendations coming from the UK-based Hutton Public Services Pensions Report (2011). Furthermore, New Brunswick has already done this within its shared-risk model in targeting maximum combined contribution at 18 percent of covered pay for its public sector plans going forward.

- *Ingrain risk management in JSPPs operations* – An important part of the risk management of pension plans is the ongoing assessment of their pension security level. This cannot be achieved solely through the typical point-in-time actuarial valuation where, too often, too much of the focus is on arriving at an appropriate discount rate; not to mention that much of the communication around the well-being of the plan can be focused on its recent return on assets. All JSPPs likely use employee asset/liability testing in the ongoing management of their plans, to varying degrees. The adoption of mandated minimum stochastic asset liability testing, together with stress testing of specific adverse events, to evaluate the long-term sustainability of the benefit/funding balance would generate a better understanding and assessment of risks and improve comparability across plans.

Lastly, there has been a call from several quarters, including the Ontario Progressive Conservative Party (2012 Ontario PC Caucus White Paper), for Ontario's public sector pension plans to convert from DB to DC. One of the key challenges with this suggestion is that it in no way addresses issues related to plan liabilities and deficits that have accumulated to date. Furthermore, DC plan members are not immune from the same trends that have stressed DB plans, such as low interest rates, poor equity returns and increased longevity. The suggestion to convert to DC is usually driven by a desire to contain costs. The recommendation I make above of incorporating target benefit concepts into JSPPs and fixing employer contribution rates would have the same effect. It would allow also for change on an evolutionary and collaborative basis, rather than on a revolutionary and confrontational one.

DB Single-Employer Pension Plans (SEPPs)

Due to the greater potential for conflict of interest resulting from their more unilateral governance structures (i.e., employers often function as the administrator and plan sponsor), SEPPs need higher standards to ensure promised benefits are delivered. The most significant requirements deal with funding and surplus utilization. But there also needs to be better balance for plan sponsors.

Ontario's two-part funding system consists of going-concern and solvency-funding rules. Conceived with good intentions in the 1980s, the solvency-funding requirements are an ongoing frustration for plan sponsors. Ontario has issued temporary easements to these requirements twice in the past 10 years, a sign that these rules are insufficient to secure pension plan promises during difficult economic times. As well, contractual inflation indexing need not be included in the pension liability calculations for solvency purposes, further weakening the credibility of Ontario's solvency requirements.

Furthermore, current solvency funding rules require large additional contributions when economic times are bad, creating the potential for trapped surpluses when times improve because of the onerous rules for removing surplus funds. Solvency valuations have a valid purpose in assessing the financial well-being of a plan, but they

need not drive funding. An important observation in the Alberta/BC JEPP report (2008) is that the test for determining plan deficits and potential remedies are two separate issues.

Current rules have not prevented plans from being insufficiently funded for long periods of time, and they certainly haven't prevented plans from terminating with deficits. Furthermore, restrictions on employers recapturing surplus have resulted in minimum funding strategies. Alternatives to this two-part system of funding have been recently proposed: for example, through New Brunswick's new shared-risk plans and Quebec's D'Amours Report (2013), which proposed an "enhanced funding method."

To some extent, current funding issues are a result of trying to support benefits that were implemented in an era when costs were substantially lower than they are today. Whether the funding problems that pension plans have encountered recently are truly a funding requirement issue or a benefit issue is a valid question, but I believe that there are still fundamental issues with current funding rules that need to be addressed.

Times have changed since the 1980s, and a new focus on funding rules is needed. Worth considering are the following two remedial measures:

- ***Replace both the going-concern and solvency-valuation requirements with a new single valuation methodology,*** based on going-concern principles but made stronger with the addition of key components – Key components would be a valuation discount rate that excludes full pre-recognition of any equity premium that may or may not arise along with shorter deficit amortization periods (e.g., eight years rather than the existing 15). This is similar to the enhanced funding method suggested in the Quebec Expert pension study (D'Amours 2013). Solvency-based testing should still be maintained for contribution holidays, though.

- ***Introduce a margin reserve account for special payments and "excess" service cost payments*** – Better symmetry could be established in the funding equation by segregating contributions meant to shore up short-term deficits and margins built into the service cost. Recent BC legislation goes in the right direction by establishing a reserve account for solvency amortization payments that could be returned to the employer regardless of the wording in the plan document. A further step would include both going-concern special payments (where there is no solvency funding) and margins in the service cost in order to reduce the possibility of future trapped surpluses.

Conclusion

While the current phase of Ontario pension reform that started in 2008 is close to completion, there is still room for significant improvements. In this *Commentary*, we have focused our suggestions in a few key areas:

- Coverage is the primary issue. It must be addressed in a focused, concrete fashion. If PRPPs are the solution, employers beyond a specified size should be mandated to offer such a plan and auto-enroll employees who would have the option to opt out. This would ensure the accumulation of assets needed to support retirement readiness and to create the scale needed to deliver on the promise of low operating costs. Furthermore, TFSAs should be integrated into the PRPP package.

- The majority of pension plan members in Ontario are in the public sector. Taxpayers would benefit from the province incorporating target-benefit principles into the standards governing these JSPPs, fixing the contribution rate for employers and ingraining risk management principles in the operation of these plans. This would help keep plan costs in line, reduce the

potential for intergenerational inequities and broaden the general understanding of these plans.

- For DB SEPPs, funding and surplus utilization are the primary areas of concern. Current funding models could benefit from replacing the combined going-concern and solvency valuation model with a stronger going concern valuation model and creating a new margin reserve account to prevent special payments made during poor financial times as well as and margins incorporated in service cost payments turning into trapped surplus when times improve.

The ultimate objective for retirement programs in Ontario presented in the Arthurs Report is still valid: affordable pension plans that are sustainable and operate within a clear set of unbiased rules. These objectives are attainable. They require merely the will to do what needs to be done.

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